Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SWD:LV:GL-802424-00
WSHarris

Chief, Examination Division, Southwest District

date:

from: District Counsel, Southwest District

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subject: **MFS Tax Returns Reflecting A Community Split of Income**

This is to advise you that the position taken by Office Audit, Examination Division, regarding division of community property income and expenses on "married filing separate" ("MFS") tax returns can not be sustained in court and is contrary to existing law. Office Audit has been disallowing MFS returns which report 50 percent of total community income and expenses ("a community split return") unless the taxpayer is able to establish an affirmative right to a community split. This appears to be based on a misguided, but long-standing, interpretation of I.R.C. § 66(b). However, a MFS return reflecting a community split is presumptively correct and the burden of proof is upon the government to establish otherwise.

FACTS

Problems with MFS returns often arise in, but are not limited to, situations involving separations and pending divorces. In most community property states, community property laws still apply in these situations. One spouse, usually the one who has earned little income, will file a timely "single" or "MFS" return and report 100 percent of his/her wages, ignoring state community property laws. The other spouse, usually a high income earner, will file a "MFS" return reflecting a 50 percent split of total community income and expenses.

Sometimes, the spouses are still married, but one spouse has filed a "MFS" return reporting only 100 percent of his/her wages. The second spouse is a nonfiler who subsequently files an untimely MFS return reflecting a community split. Because the three year statute on assessment for the return filed by the first spouse has, or is about to, expire, this leaves the Service in a "whipsaw" situation. (We note that while the six year statute for assessment frequently applies in these situations, Exams has not been asserting this.)

In the type of situations discussed above, Office Audit has often disallowed the community split reflected on one spouse's return unless the taxpayer can affirmatively establish a right to a community split. The taxpayer has frequently been required to prove that I.R.C. § 66(b), setting forth an exception to normal community property rules, is not applicable in his/her case.

An typical example of this is reflected in a letter issued by the OSC. A taxpayer who had filed a MFS return reflecting a community split of income earned prior to a divorce was informed that "in order to claim a community property split, you must provide verification that you informed your ex-spouse of the decision (to file a community split return) before the due date of the return. This can be in the form of a notarized letter from your ex-spouse, or a copy of the divorce decree with the stipulation of a community property filing for the tax year (at issue)". We are aware of similar treatment in cases handled by Office Audit in Nevada, Arizona, and Texas.

LAW

The tax consequences flowing from state community property laws were determined many decades ago by the Supreme Court of the United States, as well as the various Circuit Courts. Poe v. Seaborn, 282 U.S. 101 (1930)(Washington); Goodell v. Koch, 282 U.S. 118 (1930)(Arizona); Hopkins v. Bacon, 282 U.S. 122 (1930)(Texas); Bender v. Pfaff, 282 U.S. 127 (1930)(Louisiana); United States v. Malcolm, 282 U.S. 792 (1931)(California).

Based on the determination that married taxpayers domiciled in these community property states have an undivided one-half interest in the entire community, it has long been the law that such taxpayers must file either joint tax returns, or "MFS" tax returns which reflect one-half of total community income and expenses. United States v. Mitchell, 403 U.S. 190 (1971); Mischel v. Commissioner, T.C. Memo 1997-350 (1997); Shea v. Commissioner, 112 T.C. 183 (1999). The Supreme Court stated that this is not only a right, but an obligation, regardless of which spouse earned the community income. United States v. Malcolm, 282 U.S. 792 (1931).

While there are situations in each state where normal community property laws do not apply, a strong presumption exists that all income earned during marriage is community income. Hardy v. Commissioner, 181 F.3d 1002 (9th Cir. 1999)(Nevada); Edwards v. Commissioner, 680 F.2d 1268(9th Cir. 1982)(Arizona); Shea v. Commissioner, 112 T.C. 183 (1999)(community property

states generally); Wilcox v. Commissioner, T.C. Memo 1992-434 (New Mexico); Dooley v. Commissioner, T.C. Memo 1992-39 (Louisiana); Schmidt v. Commissioner, T.C. Memo 1981-38 (Texas); Forbush v. Commissioner, T.C. Memo 1979-214 (Idaho); Webb v. Commissioner, T.C. Memo 1996-550 (California).

The burden of proof is on the party attempting to rebut this presumption and establish that normal community property laws do not apply. Id. In a majority of community property states, evidence must be clear and convincing to rebut the community presumption. Hardy, supra (Nevada); Kern v. United States, 491 F.2d 436 (9th Cir. 1974) (Washington); Edwards v. Commissioner, 680 F.2d 1268 (9th Cir. 1982)(Arizona).

I.R.C. § 66 sets out three situations where state community property laws will be ignored when determining federal tax liability. The second situation, as set out in section 66(b), occurs where a taxpayer acted as if she/he was solely entitled to community income and failed to notify his/her spouse of the nature or amount of this income prior to the due date of the tax return.

The purpose of section 66(b)is to prevent unjust enrichment where a taxpayer fails to treat income as a community asset,(i.e., fails to share such income with spouse and children), but then attempts to claim the tax benefit connected with community income. Drummer v. Commissioner, T.C. Memo 1994-214,aff'd without published opinion, 68 F. 3d 472 (5th Cir. 1995). This provision "can be used only by (the government) in order to disallow the benefits of community property laws to a taxpayer under certain prescribed conditions." Hardy v. Commissioner, T.C. Memo 1997-97, aff'd, 181 F.3d 1002 (9th Cir. 1999). When asserted, it is an exception to normal community property rules.

This statute does not impose an affirmative burden on taxpayers to establish that section 66(b) does not apply. Rather, the Service must develop facts and admissible evidence establishing that it does. Shea v. Commissioner, 112 T.C. 183 (1999); Mischel v. Commissioner, T.C. Memo 1997-350; Sanders v. Commissioner, T.C. Memo 1986-26, aff'd, 812 F.2nd 715 (9th Cir. 1987). Additionally, the government bears the burden of proof where the notice of deficiency fails to raise section 66(b) because new facts and evidence are needed to address this exception to normal community property rules. Shea, supra; Layton v. Commissioner, T.C. Memo 1999-218.

In Mischel, supra, the Service issued a notice of deficiency to an Arizona taxpayer which ignored the application of state

community property laws. The Court noted and raised this omission on its own initiative. In holding that the taxpayer was liable for taxes only on his one-half community property interest, the Court stated that section 66(b) was not applicable because "at trial, (the Service) was unable to offer any persuasive reason why (it) was attempting to disregard the community property laws of the state of Arizona."

Similarly, in Shea v. Commissioner, 112 T.C. 183 (1999), a full Tax Court decision, the Service again issued a notice of deficiency which ignored California community property laws, and failed to reference section 66(b) as a basis for this treatment. The Court noted that "whether respondent may apply Section 66(b)and disregard community property law in determining petitioner's income requires evidence of whether petitioner acted as if he were solely entitled to the income and whether he failed to notify his wife of the nature and amount of that income." The Court would not apply section 66(b) where the government's evidence established only that the taxpayer's wife had little involvement in his business and that such business income was underreported, holding that "there is no factual basis to justify (the government's) invocation of section 66(b)."

CONCLUSION

It is prudent and appropriate for Office Audit to raise section 66(b) (as well as section 66(a)and any applicable state law exceptions to community property rules) when a MFS return reflecting a community split is filed, particularly when a potential whipsaw situation exists. The problem lies in how Office Audit is applying the burden of proof.

Office Audit is placing the burden of proof upon the taxpayer to establish that section 66(b) does not apply. However, a community split return is presumptively correct. Thus, before the Service determines that section 66(b) applies, Office Audit must develop evidence that supports this determination. In the absence of such facts, a community split return should be allowed, even where the return filed by the taxpayer's spouse does not reflect a community split. Where section 66(b) is asserted, it must be clearly reflected in the notice of deficiency.

When a community split return is filed, we advise Office Audit to pull the tax return of the related spouse and open two separate audits of both spouses. If the normal three year statute for assessment has expired against one spouse, the six year statute for assessment does not apply, and no basis for

asserting civil fraud exists, the Service is without recourse against the spouse. However, this is inconsequential with regard to the validity of the community split return filed by the taxpayer.

We recommend that Examination Division address and resolve this problem soon. Many Office Audit employees are resistant to changing such a long standing policy without written guidance from the upper management of the Examination Division. Accordingly, corrective instruction from your office will be necessary to facilitate needed changes in Southwest District Office Audit. In this regard, we would be happy to work with you in drafting a condensed version of this memorandum for dissemination to Office Audit, or in providing relevant training.

This advice has been reviewed and approved by our National Office. National Office has also agreed to issue a Service Center Advice on this topic. Please contact me after you have reviewed this memorandum to discuss how best to proceed.

Doreen Susi
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